**MEMORANDUM**

TO: Commissioners, Kate, Justin, Will, Eric Eck, Jason, and Scott

FROM: Neil Templeton

DATE: August 21, 2015

RE: Dockets No. D2013.5.34 and D2014.5.47 Staff Analysis and Recommendations

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## I. Purpose

This memo provides analysis of the technical arguments submitted on contested issues in Consolidated Dockets No. D2013.5.34 and D2014.5.47, the annual gas tracker of NorthWestern Energy (NorthWestern). Based on the analysis, we provide recommendations.

## II. Background

NorthWestern tracks its annual natural gas supply costs in monthly installments with annual true-up. The tracker provides an accounting platform for natural gas expenditures and loads. The platform facilitates the establishment of rates to recover projected expenditures and amortize current and prior period deferred expenditure balances. Expenditures include natural gas purchase and transportation costs, the operating costs of natural gas production and storage properties, administrative expenses, financial return on stored gas, and lost revenues associated with estimated savings from NorthWestern's energy efficiency investments.

The annual tracker also establishes a rate to amortize the gas transportation adjustment clause (GTAC) current and prior period balances. These balances reflect the difference between actual off-system and interruptible transportation sales revenues and those approved by the Commission in the last rate case. If actual and off-system transportation revenues exceed test year projected revenues, customers are credited the excess through the GTAC amortization rate. If actual revenues are less than projected, NorthWestern receives the credit. The GTAC rate is also used to calculate the Transportation Business Unit (TBU) transmission commodity rate. NorthWestern's proposed GTAC amortization rate is not contested in this proceeding.

The annual tracker is used to carry the approved Battle Creek production field fixed cost rate, and interim "bridge" rates to recover fixed costs from the Bear Paw (NFR) and Devon production fields. Heretofore these rates have been carried in the tracker as natural gas supply costs not subject to annual adjustment. The Commission approved the Battle Creek rates in Docket D2012.9.94, a general rate review docket. NorthWestern has proposed to bring its NFR and Devon properties in for Commission approval and rate review in a future general rate case.

Parties to this proceeding are NorthWestern and the Montana Consumer Counsel (MCC). The MCC is contesting NorthWestern's recovery of USB-related lost revenues and its current rate treatment of natural gas production asset fixed costs. The table below contains information regarding witnesses, hearing exhibits, and hearing transcript references that may facilitate an assessment of the evidentiary record and staff's analysis and recommendations.

**Exhibits and Transcript Reference by Witness**

| Witness | Exhibits | Transcript Reference |
|---|---|---|
| Patrick DiFronzo | NWE-1 Direct 2013; NWE-2 Direct 2014; NWE-3 Rebuttal | Tr. 21:6-32:25 |
| John Smith | NWE-4 Direct 2013; NWE-5 Supplemental 2013; NWE-6 Direct 2014; NWE-7 Supplemental 2013-14 | Tr. 40:17-50:19 |
| Marjorie McRae | NWE-8 Direct | Tr. 53:17-66:7 |
| Michael Baker | NWE-9 Direct | Tr. 69:12-76:2 |
| Faith DeBolt | NWE-10 Direct | NA |
| William Thomas | NWE-11 Direct 2013; NWE-12 Supplemental 2013; NWE-13 Direct 2014 | NA |
| Joe Schwartzenberger | NWE-14 Supplemental 2013-14; NWE-15 Rebuttal | Tr. 86:4-105:18 |
| George Donkin | MCC-1 Direct 2013; MCC-2 Direct 2014 | Tr. 121:8-141:1 |

## III. Staff Analysis and Recommendations

*First Contested Issue – Disallowing lost revenue Recovery for USB Savings*

On November 27, 2013, Donkin prefiled direct testimony on behalf of MCC. He proposed that the Commission disallow recovery of NorthWestern's claimed lost revenues due to savings associated with investments in its universal system benefit (USB) weatherization and energy audit programs. Lost revenues are the estimated fixed cost revenues that would be recovered through volumetric rates but for the program savings. The fixed costs are associated with NorthWestern's transmission, distribution, storage, and Battle Creek assets.

USB program costs are recovered in USB trackers, but USB-related lost revenues have been recovered in the natural gas supply trackers.

On March 18, 2015, Donkin prefiled direct testimony in Consolidated Dockets No. D2013.5.34 and D2014.5.47. Donkin recommended that the Commission disallow recovery of USB-related lost revenues in 2012-13, 2013-14, and future tracker periods. Schwartzenberger rebutted Donkin's testimony on behalf of NorthWestern on April 24, 2015.

On April 24, 2015, NorthWestern moved to reserve decision on this issue until after the Commission issues a final order in the LRAM proceeding, Docket No. D2014.6.53, and to strike Donkin's testimony regarding the issue. MCC responded on May 11, 2015, and NorthWestern replied to MCC's response on May 15, 2015. The Commission deliberated NorthWestern's motions at a work session On May 18, 2015. It denied NorthWestern's motion to strike testimony, and took its motion to reserve issue under advisement until a final order is issued in these consolidated gas trackers.

*Testimony in Support of Differential Treatment for USB-Related Lost Revenues*

- Automatic interim rate adjustments best apply to significant costs that are largely beyond control, such as purchased gas costs. The adjustments are single-issue devices that do not account for other cost changes that might offset the costs to be adjusted. (MCC-1, 5:10-13, 6:17-7:11, 15:10-11; MCC-2, 5:16-6:4; Tr. 128:20-25).

- Automatic interim rate adjustments can reduce business risk, relative to the risk assumed by the Commission in establishing the authorized cost of capital. If so, non-gas cost interim adjustments may produce an actual return on capital in excess of the utility's actual cost of capital. (MCC-1, 7:12-18; MCC-2, 6:5-11; Tr. 121:15-123:16).

- Automatic interim rate adjustments may reduce cost control incentive. (MCC-1, 8:1-2; MCC-2, 6:12-13).

- USB investments are mandated in statute, so removing lost revenue recovery would not create a disincentive to invest. (MCC-1, 16:9-14; MCC-2, 8:14-9:7, 16:11-19).

- NorthWestern's USB energy efficiency investments are not cost effective. Customers are no longer receiving positive net present value benefits from the program investments. (MCC-1, 8:6-14:15, 15:11-18; MCC-2, 6:14-8:13, 11:2-15:6, 17:1-9; Tr. 129:2-7).
- The Montana Department of Revenue defines cost-effective to mean that the expected benefits must exceed the expected cost over a reasonable period. (MCC-2, 15:11-17).

*Testimony in Support of USB-Related Lost Revenue Recovery*

- Donkin did not calculate USB-related lost revenues correctly. (NWE-15, 7:3-8:2).
- Although NorthWestern is statutorily required to provide natural gas USB programs, it should not be penalized for following the law. (NWE-15, 8:18-22, 27:17-20).
- Whether or not demand-side programs are required by law, the purpose and merit of lost revenues is to remove the throughput disincentive. (Tr. 95:7-23).
- USB programs should not be evaluated strictly by a resource value metric. These programs continue to promote public policy consistent with Montana law, administrative rule, and Commission orders. (NWE-15, 9:14-10:10, 11:6-12:2, 26:15-27:15).
- To estimate gas costs, Donkin used average gas commodity costs rather than appropriate long-run avoided costs including environmental costs. (NWE-15, 10:14-23).
- The rules adopted by the Montana Department of Revenue regarding energy conservation cost-effectiveness apply to electric USB rather than natural gas. Statute and Commission rules that apply to natural gas USB do not define cost-effectiveness, and do not apply the term to low income weatherization. (NWE-15, 13:4-14:17).
- NorthWestern's share of qualified weatherization costs in 2013 and 2014 increased due to an agreement to improve the weatherization program and changes to federal funding. The agreement was collaborative with the Department of Health and Human Services and affected Human Resource Councils. Administrative efficiency improved but fewer homes were weatherized. (NWE-15, 15:13-19:13).
- Cost-effectiveness is considered in weatherization. (NWE-15, 19:18-20:5).

- The weatherization and energy audit programs provide numerous benefits in addition to natural gas savings. (NWE-15, 21:9-22:18).
- NorthWestern extended Donkin's analysis, including savings from 2006-07 to 2012-13 rather than 2012-13 to 2013-14, and showed the programs were cost-effective using a different analytical method. (NWE-15, 24:20-25:5, Exhibit_(JS-3), 27:22-28:3).
- NorthWestern's cost of capital for its natural gas utility has been evaluated in three general filings since lost revenues were authorized in 2005. (NWE-15, 25:15-20).

Recommendation

Staff recommends that for program periods 2012-13 and 2013-14 the Commission treat USB-related lost revenues on parity with the lost revenues associated with NorthWestern's other energy efficiency and conservation investments. It is true that USB programs are statutory. It is also true that NorthWestern's remaining DSM programs have been implemented in response to mandates in statute, administrative rule, and Commission order that NorthWestern pursue cost-effective energy efficiency resources as part of a reliable, long-term, least-cost portfolio. The requirement to invest in conservation resources is similar in effect in both cases, and does not recommend differential treatment.

The Commission addressed this issue in a previous order: "The Commission observes that the policy of allowing lost revenue recovery for USB programs appears particularly questionable given that such programs are required by law." (Order 7219h ¶ 78). This finding appears to provide support to deny recovery of USB-related lost revenues. However, consistent with the arguments above, staff recommends that the Commission recognize that NorthWestern is required by statute and rule to pursue procurement of *all* cost-effective DSM resources. The Commission should not discriminate between USB and other DSM programs solely on the basis of statutory requirement.

Finally, the recovery of lost revenues is being addressed by the Commission in Docket No. D2014.6.53, which is currently in its post-hearing briefing phase. The evidentiary record in Docket No. D2014.6.53 is stocked with testimony from all parties regarding the use of lost revenue recovery as a tool to remove NorthWestern's throughput disincentive to invest in conservation and energy efficiency. Staff believes that the record in D2014.6.53 provides a more thorough elucidation of the economic issues and a stronger platform for the determination of a prudent policy for the ongoing treatment of USB and DSM-related lost revenues.

Staff recommends that the Commission allow recovery of USB-related lost revenues in 2012-13 and 2013-14. For treatment of USB-related lost revenues in the period July 1, 2014 through June 30, 2015, and going forward, the Commission should reserve the issue for consideration in Docket No. 2014.7.59 and Docket No. D2014.6.53.

*Second Contested Issue – Adjusting Fixed-Cost Rates for Natural Gas Production Assets*

On March 18, 2015, Donkin testified that NorthWestern has been using outdated revenue requirement data to recover the fixed costs of its natural gas producing properties: Battle Creek, NFR, and Devon. Donkin recommended that the Commission direct NorthWestern to make a filing that presents actual cost of service support for rates in all tracker periods through June 2015. He also recommended that the Commission replace the "bridging" rates in the tracker with actual cost based rates, updated annually, resulting from the current fixed cost revenue requirements for each property. (MCC-2, 30:17-31:14, DR PSC-046, DR PSC-047).

DiFronzo filed rebuttal testimony on this issue April 24, 2015. He testified that the Commission authorized the acquisition of the Battle Creek property and established its fixed cost recovery rate in Docket No. D2012.3.25, and later adjusted the rate in Docket No. D2012.9.94, a natural gas utility general rate case.

*Testimony/Evidence in Support of Interim Adjustments to Production Asset Rates*

- In response to data requests PSC-041(a) and PSC-042(b), NorthWestern provided Excel spreadsheets that showed analysis performed in its evaluation of the NFR and Devon natural gas production properties. The spreadsheets show revenue requirements that decline annually over the lives of the properties.
- If the NFR and Devon rates were adjusted to reflect the 2014-15 revenue requirements shown in the evaluation analysis, the total gas cost revenue reduction would be approximately $2.5 million. (MCC-2, 28:17-29:11, Exhibit_(GLD-6), Exhibit_(GLD-7)).
- The NorthWestern analyses with declining annual revenue requirements underlie the net present value analyses used to establish the cost-effectiveness of the gas

production properties, including unit cost crossover point estimates that satisfied the stipulation between NorthWestern and MCC. If rates are not adjusted to reflect the declining revenue requirements, customers will pay more than anticipated in evaluations presented to the Commission, and the net present value comparisons to natural gas purchases at expected market prices will be invalid. (DR PSC-046(c); Tr. 22:17-24:11, 126:24-127:12, 132:3-133:22, 134:13-137:13).

- The bridging mechanism allows NorthWestern to include production purchases such as Battle Creek, NFR, and Devon immediately in rates through the tracker. Production is purchased to substitute for market buys. Changes in market purchase costs are reflected fairly quickly in the tracker. (Tr. 40:24-42:10).

*Testimony in Support of the Current Rate-Setting Methodology*

- The approved fixed cost rate for the Battle Creek field is not an interim bridge rate. Battle Creek was included into rate base at $0.1252/Dkt in Order No. 7210b, Docket No. D2012.3.25. This rate was reduced to its current value, $0.1237/Dkt, in Order No. 7249e, Docket No. D2012.9.94, the most recent general rate case for NorthWestern's natural gas utility. (NWE-3, 2:10-3:5; Tr. 21:22-22:9).
- The current Battle Creek fixed cost rate should remain in place until an updated revenue requirement is approved by the Commission within a general rate case. Adjustment of prior periods would be retroactive ratemaking. (NWE-3, 3:7-17).
- The interim bridge rates for the NFR and Devon assets should be adjusted to actual cost of service when NorthWestern makes the respective filings to review and approve the acquisitions into rate base. (NWE-3, 3:21-4:2).
- NorthWestern plans to include the NFR and Devon asset review filings with a consolidated natural gas utility rate review in 2016. If the interim bridge rates exceed approved rates, customers would be refunded the overcharge consistent with Commission practice. (NWE-3, 4:7-5:3; Tr. 25:21-26:23).
- Elimination of bridge rates would preclude acquisition of additional natural gas production resources. (NorthWestern Post-Hearing Brief, p.3).

Recommendation

Staff recommends that the Commission continue to modify the Battle Creek fixed cost rate within the context of general rate cases. This asset has been approved by the Commission for inclusion into rate base in Order No. 7210b, and treated on parity with other natural gas utility rate based assets with respect to rate treatment in Order No. 7249e. To alter its treatment at this time would be a remarkable departure from precedent and is not advised.

NorthWestern has not filed for Commission review and inclusion into rate base of the NFR and Devon natural gas production purchases. The current fixed cost rates for these assets are the interim bridge rates. The Commission has approved interim rates for these purchases pending a future revenue requirement filing. (Order No. 7282b, ¶ 11).

Since NorthWestern has testified that it plans to file for general rate review in 2016, staff recommends that the Commission reaffirm its interim order and postpone determination of appropriate rate treatment for these assets until that time.

*Additional Issue Regarding Order No. 7219h.*

On December 19, 2013, the Commission directed NWE to supplement its 2012-2013 Natural Gas Supply Tracker filing with a response regarding Findings of Fact ¶ 40-79 in Order No. 7219h, involving adjustments to lost revenues and lost revenue policy that might be applicable to the natural gas tracker application and proceeding. Joe Schwartzenberger addressed this issue in supplemental testimony on December 5, 2014. (NWE-14, 9:21-13:7).

Schwartzenberger testified that NorthWestern had previously adjusted its lost revenue estimates to comply with ¶ 44 of the order, removing savings derived from conservation investments in its own properties. (Id. 10:10-19). He stated that NorthWestern has also adjusted natural gas savings to comply with direction regarding the DEQ appliance program in ¶ 70 of the order. (Id. 12:5-18). He also stated that ¶¶ 78-79 of the order have been mooted or met in Order No. 7219i and the LRAM policy Docket No. 2014.6.53. (Id. 12:20-13:7).

Regarding the free-ridership and spillover adjustments that the Commission applied to electric savings in ¶¶ 47-59 and ¶ 76 of Order 7219h, Schwartzenberger testified that a decision on this issue is pending in district court. (Id. 11:18-20). NorthWestern has not applied the commensurate adjustments to natural gas savings, and rather has adopted a net-to-gross factor of one, as supported in prefiled direct testimony. (Id. 11:20-12:3; NWE-8, 4:14-5:4).

Recommendation

Staff recommends that the Commission order NorthWestern to make all free-ridership and spillover adjustments to its natural gas savings estimates necessary to be consistent with Commission direction in Order No. 7219h, pending a final decision in Cause No. DV-13-399, Montana Second Judicial District Court. Dr. McRae has agreed that her testimony on free-ridership and spillover with respect to electric energy efficiency programs would not change fundamentally if the context were natural gas efficiency programs. (Tr. 53:22-54:19). The appropriate adjustments are expressed in the estimates of free-ridership, spillover, and net adjusted natural gas savings. (Exhibit PSC-2).